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TAGS: EFIN ECON ELAB ALOW AR
SUBJECT: Argentina Economic and Financial Weekly for
the week ending January 20, 2006

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Weekly Highlights
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- The peso appreciated 0.3 percent against the USD, closing at 3.05 ARP/USD.
- Kirchner, Lula and Chavez commit to completing a South American pipeline project.
- GOA still trying to reach new price-restraint agreements.
- BCRA will re-launch its market expectations consensus survey in February.
- December industrial production index up 7.9 percent y-o-y.
- November monthly economic activity index up 9.1 percent y-o-y, stronger than expected.
- Commentary of the Week: "The Political Dilemma of the Anti-Inflation Policy"

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MARKETS
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The peso appreciated 0.3 percent against the USD during the week to close at 3.05 ARP/USD.
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¶1. The peso appreciated 0.3 percent versus the USD during the week to close at 3.05 ARP/USD, one cent below last Friday's close. This week's appreciation is mainly attributed to higher dollar sales by exporters, accompanied by the Central Bank's constant intervention in the FX market to prevent the peso from appreciating too much. During the week, the BCRA purchased USD 102 million and EUR 17.5 million, helping the BCRA rebuild its reserves following the GOA's prepayment of its IMF debt. The peso exchange rate is unchanged from the beginning of year.

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ECONOMY / FINANCE
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Kirchner, Lula and Chavez commit to develop a South

American pipeline project.
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¶2. Argentine President Kirchner, Venezuelan President Chavez and Brazilian President Lula da Silva met in Brazil on January 19 and confirmed plans to develop an 8,000-kilometer (5,000-mile) natural gas pipeline linking Caracas and Buenos Aires, cutting through the Brazilian Amazon rain forest and parts of Bolivia, Paraguay and Uruguay. The three presidents committed their "political will" to complete the project and will meet again on March 10 in Mendoza (Argentina) to continue discussions. The project is expected to be launched publicly in July. Chavez said that each of the three countries would contribute to financing the pipeline with an estimated price tag of USD 12-20 billion, and also mentioned that some Asian companies are interested in participating in the project.

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Lula da Silva wants improved commercial relations with Argentina.
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¶3. President Kirchner met Brazilian President Lula Da Silva in Brasilia on January 18. Lula Da Silva expressed his interest in contributing to Argentina's industrial development and to decreasing existing asymmetries. He also mentioned that Brazil would consider new proposals to improve the commercial relationship between the two countries, an apparent reference to a GOA proposal that would allow Argentina to take safeguard actions against surging Brazilian imports.

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Felisa Miceli - there is enough credit in Argentina to finance companies' investment projects.
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¶4. During her trip to Brazil, Minister of Economy Felisa Miceli said that Argentina is offering loans to companies on better financial terms than Brazil does. She added that Argentina's financial system is strong enough to finance every company's investment project.

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GOA is still trying to reach price-restraint agreements.
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¶5. GOA officials met again this week with leading companies in an attempt to reach new price-restraint agreements. On January 16, the GOA closed an agreement with chicken producers to maintain chicken prices unchanged until the end of the year. The GOA also reached new agreements with cement companies and dairy producers (until the end-of the year but with bi-monthly monitoring to adjust prices in case economic conditions change substantially). The GOA will continue to press for price-restraint agreements with firms from different sectors. Its goal is to create a basket of basic goods with voluntarily-controlled prices in coming weeks. In an interview on January 19, President Kirchner defended the strategy of using price-restraint agreements as a middle point between price freezes and increasing interest rates, which could jeopardize economic growth. In spite of GOA's attempts to keep inflation under control with price restraints, food prices are expected to increase from 0.3 percent to 1 percent m-o-m in January, according to private consulting firms. The BCRA consensus survey (from January 4 - the latest release available) is forecasting a 1.3 percent m-o-m increase in January.

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BCRA will re-introduce a revised, monthly market expectation consensus survey in February.
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¶6. On January 18, the BCRA announced that it will use a new methodology in its market expectation consensus survey. The new version will use new variables such as the 7-day repo rate, the Badlar rate and M2 (currency in circulation plus checking and saving accounts) instead of the monetary base. Leading companies with in-house research will now participate in the survey, joining the 50 contributing banks, brokers, consulting firms and universities that already participate. The first of consensus survey using these new criteria will be published on February 3 and updated on a monthly, rather than weekly, basis.

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BCRA maintains Lebacs' interest rates; Demand concentrated at the short end of the curve.
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¶7. The BCRA received bids of ARP 1.2 billion in its January 17 Lebac auction, above the ARP 1.1 billion announced amount but below the ARP 1.3 billion in Lebacs that came due during the week. Investors concentrated 80 percent of their bids for ARP Lebacs in the short-end of the curve (less than 3 months). Like the last three auctions, the BCRA was unable to roll over its maturities, accepting bids for ARP 1.0 billion. The yield on the 49 -day Lebac remained unchanged at 6.76 percent, while the yield on the 77-day Lebac dropped 6 basis points to 6.90 percent. Lebacs for maturities of more than 3 months were withdrawn again due to lack of interest.

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Banks reduce their exposure to the public sector by 9 percentage points in the first eleven months of 2005.
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¶8. The BCRA reported that the banking system reduced its exposure to public sector debt by 9 percentage points in the first eleven months of 2005, reducing it to 30.9 percent of total assets. According to the report, the decrease in exposure is the result of net sales of GOA debt in bank's portfolios, the re-valuation by some banks of GOA instruments at market value, and bank's finally receiving long-pending compensation in cash. The BCRA report also said that the financial system posted profits of ARP 170 million in November, bringing its accumulated profits to ARP 1.7 billion during the first eleven months of 2005.

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November monthly economic activity index up 9.1 percent yoy - stronger than expected.
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¶9. The monthly economic activity index increased a strong 9.1 percent y-o-y in November, well above the BCRA market survey forecast of 8.3 percent, and bringing the cumulative growth for the first eleven months of 2005 to 9.2 percent. The index increased 0.9 percent m-o-m, following a 0.8 percent m-o-m rise in October. The BCRA consensus survey estimates 2005 growth in the index at 8.7 percent. The index is viewed as a reliable leading indicator of GDP. Minister of Economy Miceli stated at the end of December that GDP growth would exceed 8.5 percent in ¶2005.

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December industrial production index up 7.9 percent y-o-y.
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¶10. The industrial production index increased 7.9

percent y-o-y in December, bringing total annual growth to 7.7 percent for 2005, a strong level of growth following the 10.7 percent growth in 2004. During December, the fastest-growing sectors were textiles (up 21 percent), minerals (up 18 percent), and plastic and rubber (up 14 percent). The index decreased 3.8 percent m-o-m.

¶11. The industry-wide capacity utilization index reached 69.0 percent in December, compared to 68.5 percent in December 2004. The sectors showing the highest capacity utilization were metal based industries (93.7 percent), oil refining (93.4 percent), and paper and carton (77.8 percent). The sectors with the lowest capacity utilization were auto production (34.4 percent), metal-mechanical excluding cars (56.4 percent), and non-metallic minerals (59.2 percent). For 2005, the average industry- wide capacity utilization index was 71.1 percent.

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January Consumer Confidence Index up 11.9 percent m-o-m.

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¶12. The Consumer Confidence Index- published by Universidad T. Di Tella - jumped 11.9 percent m-o-m in January to 57.1 points, after dropping 4.4 percent in December. The significant increase in January is attributed mainly to highly positive expectations about consumer's willingness to purchase durable goods and real estate (16.11 percent increase m-o-m) and consumers' sentiment towards the macroeconomic environment (13.71 percent m-o-m), followed by positive expectations on individual's personal situation (7.29 percent). The index is now only 5

percent below its all-time high, reached in February 2004 and 2 percent below the 2005 high point, reached last February. The index increased 0.45 percent y-o-y. The index is based on surveys of individual economic sentiment and consumer willingness to purchase durable goods, houses and cars.

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Commentary of the Week: "The Political Dilemma of the Anti-Inflation Policy" by SEL Consultores, December 2005 -January 2006 (Translated and abridged with permission)

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¶13. The design and effectiveness of an anti-inflation policy depends, more than anything else, on the correct diagnosis of the causes of inflation. If, as the Ministry of Economy initially argued, the current inflation is just a re-accommodation of relative prices (which could be read as saying "the crisis has ended") there isn't much to do except try to moderate the speed of the process; prices will re-stabilize once they reach a new equilibrium.

¶14. The difficulty with this interpretation ... is that the growth in CPI continues to be mainly in those prices that have grown the most since devaluation. The components of the index that increased the most in 2005 were Housing and Basic Services (16.4 percent increase), and Education (16.0 percent); but they were only one-fifth of the increase in the cost of the basket of goods. If these components had stayed stable all year, 2005 inflation (through November) still would have been 8.6 percent, i.e., 2.5 percent above 2004 ... Meanwhile, the CPI component with the largest potential for re-accommodation increases -- Regulated Goods and Services, which makes up 20.1 percent of the CPI -- grew only 2.9 percent in 2005, versus core inflation of 12.5 percent, while in 2004 it grew 5.1 percent versus core inflation of 6.4

percent. In other words, the re-accommodation of relative prices is still to come.

¶15. A second diagnosis of the current inflation is that it results from a scarcity of supply. But that is difficult to believe in an economy that has grown 9 percent per year for three consecutive years, two of them with low inflation ... A third diagnosis is that it results from oligopolistic practices ... but it is difficult to believe that these could explain economy-wide price increases, including in the most competitive sectors. In any case, the main problem with this diagnosis is that it posits a micro-economic cause of inflation that can be addressed by administrative means ... but inflation is a macro-economic phenomenon that requires macro-economic tools.

¶16. This means that we have to look at the rate of aggregate demand growth and the policies that produce it. Aggregate demand is, in effect, increasing at a 12 percent annual rate, i.e., three points above the elevated growth of total supply. This is the result of a monetary policy aimed at protecting the exchange rate; the expansion of public spending; and increases in formal sector salaries. M2 grew 20 percent in 2005 ... Primary public spending grew 24.7 percent thru the third quarter ... average salaries grew 18.8 percent and formal-sector private salaries grew 23.7 percent (at an annual rate through October).

¶17. It seems likely, therefore, that domestic demand stimulated by these policies is creating price pressures. This is happening at the same time as external demand is growing significantly (13 percent export growth in the third quarter) which, especially in food, competes with domestic demand and pushes consumer prices higher.

¶18. The classical answer to demand-driven inflation is to decelerate it through a combination of restrictive monetary and fiscal policies and a moderation of salary increases. But this creates a political problem that is difficult to resolve. A restrictive monetary policy would require a reduction in intervention in exchange markets and an appreciation of the peso. While this would increase buying power ... it would result in a loss of competitiveness in tradable goods, especially in import substitution sectors such as manufacturing. The political downside of this outweighs the economic benefit.

¶19. Similarly, a policy of salary moderation in the private sector would be rejected by labor unions. ... While real salaries of formal, private sector salaries have recovered -- and even exceeded -- their losses following devaluation ... taking into account all the segments of the labor market, the real average salary is almost 9 percent below what it was in 2001 and the share of real salaries in GDP increased only 12 percent compared to a real GDP growth of 25 percent during the same period.... in this situation, it is unlikely that labor unions will accept a policy of salary restrictions ...

¶20. The political dilemma, then, is that if the government uses restrictive macro-economic policies to control inflation, it will lose the support of the social coalition that, until now, has been its most solid base of support, as well as it will reduce the government's own resources... if the government wants to continue to receive their support, it will have to resign itself to maintaining inflation in a tolerable range ... The question then is, how much inflation is society willing to accept? [Note: We reproduce selected articles by local experts for the benefit of our readers. The opinions expressed are those of the

authors, not of the Embassy. End Note.]

GUTIERREZ